Business Finance Review

UK Finance provides a regular analysis of how the finance needs of small and medium-sized enterprises (SMEs) are being supported through lending from mainstream lenders and specialised finance providers and looks at their deposit holdings. This latest *Business Finance Review* provides a round-up of lending activity to SMEs against the backdrop of a slowing economy and an uncertain year ahead.

Stephen Pegge, Managing Director of Commercial Finance, comments:

"As the UK economy enters choppier waters, SMEs have become more cautious in their outlook and this is reflected in a more subdued appetite for finance. Demand has, however, been somewhat stronger for products which help with cashflow management, such as overdrafts and, more notably, invoice finance and asset-based lending products.

"SMEs are however continuing to meet debt repayment obligations on the back of more significant borrowing during the Covid-19 pandemic.

"With the UK economic outlook expected to deteriorate further in the early part of 2023, SME growth plans and investment are likely to remain cautious over the coming quarters. The recent energy support package from government will help businesses manage some of the near-term cost pressures. In addition, data continue to point to a good degree of headroom across existing facilities and deposits. But business that need further finance support, whether that be to manage existing obligations or for new opportunities are encouraged to have an early conversation with their lender."

2022 Q3 HIGHLIGHTS

- **Overdraft applications continued to trend up in the third quarter, but demand for loans softened further. Sector variation becomes more significant.**
- **Overdraft utilisation remains broadly stable.**
- **Invoice Finance/Asset-based lending (IF/ABL) advances continue to grow but at slower pace than in H1.**
- **Across both overdrafts and IF/ABL businesses continue to have access to funding in existing facilities.**
- **Repayments drop back slightly but remain above pre-pandemic levels.**
- **SMEs holding on to cash as deposits largely unchanged over the quarter.**

Economic outlook

The backdrop to this third quarter Business Finance Review is one of continued economic weakness – at home and overseas – with forecasts increasingly pointing to further deterioration ahead.

GDP contracted by 0.2 per cent in the three months to September after ONS revisions confirmed some modest growth in Q2. Those revisions also leave the UK economy smaller than previously thought and with output lower than before the pandemic.

Weakness in Q3 was fairly broad based. Services activity was flat, but there were falls in consumer-facing services, notably retail. While data are affected by the Queen's funeral in September, there is increasing evidence that cost-of-living pressures facing households are beginning to bite.

Elsewhere, manufacturing saw a two per cent drop in output over the quarter (see the sector spotlight for more detail), but construction activity rose on the back of new projects.

Initial readings for Q4 from survey indicators point to continued weakness ahead. The October services PMI was the lowest since January 2020, signalling contracting activity, and optimism about the year ahead fell sharply. The picture was similarly negative across the manufacturing PMI with weak demand at home and a protracted period of weakness in overseas orders reported. Data would confirm the OBR view that the UK is currently in recession.

Survey indicators of business sentiment confirm that the areas of concern that we have been reporting in recent reviews continue to make their presence felt. A clear read out from the PMI surveys is that inflationary pressures continue to bear down on demand. The regular ONS Business Conditions Survey shows that energy prices and inflation are the top concerns across SMEs of all sizes.

Many sectors have also experienced a challenging labour market this year, facing difficulties filling vacancies and upward pressure on pay demands. Recruitment plans may, however, be starting to soften. The manufacturing PMI, for example, pointed to job losses in October and the ONS BICs survey shows expectations that job numbers are likely to decrease in hospitality.

Total business investment remains more than eight per cent below pre-Covid-19 levels. While there was a brief recovery in Q2, investment resumed its slide in Q3. While the super deduction tax relief for investment has been in place, ONS observes that few respondents have noted it as a factor driving investment in the quarterly survey. Rather the Bank of England Agents' report notes that in the latest quarter there was a rise in firms reporting delaying investments because of uncertainty and tighter financial positions.

While the economic data point to challenges and uncertainties facing many SMEs, in Q3 it was politics at the centre of a new wave of uncertainty for businesses and households. The mini-Budget from the (then) new prime minister and chancellor announced a substantial package of measures to shield businesses and consumers from massive hikes in energy prices going into the winter. And in addition, markets were surprised by a suite of further measures to cut taxes for individuals and corporations.

While the chancellor's statement presented the measures as growth-enhancing, financial markets took fright at the scale and unfunded nature of the package, sending government borrowing costs soaring and pushing sterling below $1.10. There were significant consequences for mortgage rates and the availability of products.

A change of chancellor followed, which led to the reversal of almost all of the tax cuts and a shortening of the duration of the energy price support package for households, which calmed markets, bringing gilt yields down and stabilising the pound.

We have subsequently had a further change in Number 10 and a fully costed autumn statement accompanied by an assessment of the economic and fiscal outlook by the Office for Budget Responsibility.

The fiscal direction has shifted from tax cutting to tax raising, though notably much of the heavy lifting from freezing tax thresholds, for example, has been pushed out until 2024 and beyond. It was a mixed bag for businesses. On the plus side the annual investment allowance will be permanently set at £1 million, meaning SMEs will be able to immediately offset much of their investment against tax. The business rates multiplier has also been frozen.

However, an increase in fuel duty, some changes to the R&D tax credit and freezing employer NIC thresholds will be less welcomed by businesses.

Markets took this statement in their stride and expectations of future Bank Rate increases moderated further. However, the OBR's economic assessment did not make for cheery reading. It expects a prolonged period of economic contraction through much of next year, resulting in a 1.4 per cent fall in GDP in 2023. The significant squeeze in household disposable incomes and weak consumption outlook are major factors in the forecast downgrades.

Unemployment is also expected to pick up next year and through 2024. From a business perspective, the outlook for investment is particularly poor. It expects business investment to contract by over two per cent next year (more than the fall in GDP). While the decision to make the £1 million annual investment allowance permanent will have a small impact on investment; the OBR expects investment to be over eight per cent below 2019Q4 levels at the start of 2027.

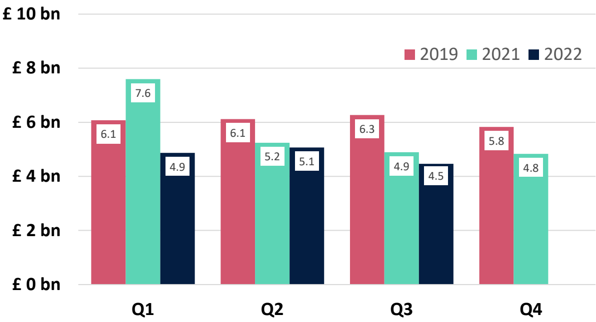
While SMEs have proved their resilience time and again, not least through the Covid-19 period, the coming quarters will inevitably present challenges to businesses. These will not be unique to the UK, with slowing growth and elevated and persistent inflation dogging the global economy, however these uncertainties are becoming evident in our finance data for SMEs.

SME finance

Last quarter we reported some growth in gross lending to SMEs in Q2, but some softening in applications for finance, particularly loans, which suggested that future lending by the main high street banks would likely drift down. The latest information from this market segment confirms that this was indeed the case in the third quarter.

Gross lending to SMEs edged down to £4.5 billion from £5.1 billion in the previous quarter ***(Chart 1)***. Looking at the monthly profile of gross lending, the weakness was concentrated in lending during July and August, with something of a rebound back to Q2 levels in September.

Chart 1: Gross lending to SMEs through loans and overdrafts



Source: UK Finance

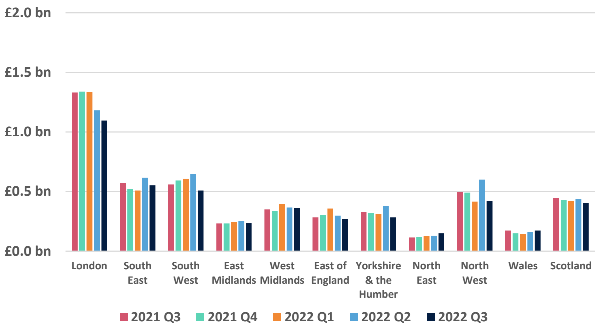
The regional variation in lending that we saw through the first half of 2022 persisted in the most recent quarter, as shown in ***Chart 2***.

Last quarter we noted increases in gross lending to SMEs in the North West and the South East of England. In these regions that growth has unwound in Q3 with lending returning to trends closer to that seen at the end of 2021 and early months of 2022.

In the South West, however, the drop in gross lending was more marked after a sustained period over quarter-on-quarter increases recorded over the previous year. This could be related to the particular decline in finance applications from the agricultural sector, which is disproportionately represented in the region.

The other standout region, in terms of lending trends, is London, which has seen two quarters of declining lending values. In the remaining GB regions, the picture remains one of relative stability at levels similar to those seen prior to the Covid-19 pandemic.

Chart 2: Gross lending by region



Source: UK Finance

As reported at the beginning of this section, we attribute the fall back in lending this quarter to the softening in new loan applications in the previous quarter. The applications picture followed a similar downward trend in Q3 to that seen in the three months to June, although the rate of decline has slowed.

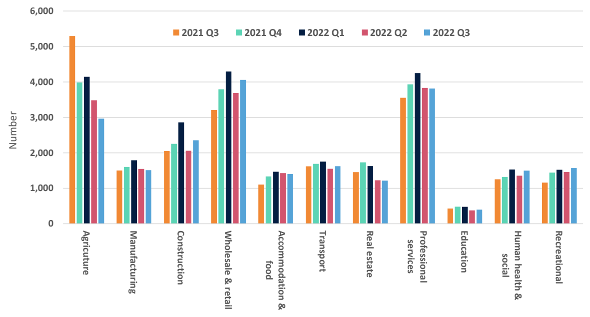
Economic uncertainty will be a key factor in SMEs decisions to invest or make major changes to their businesses that might require additional external finance. We noted in the introduction that business investment contracted in the third quarter and evidence from business surveys is mounting about the increasingly downbeat outlook amongst firms about near-term growth prospects. This includes recent findings from the SME Finance Monitor showing that the proportion of SMEs that see the economic climate as an obstacle to running their business, while down on Covid-19 era levels, is significantly above 2018/19 levels.

While the turbulence in financial markets that pushed up some borrowing costs came right at the end of the quarter, the steady increase in Bank Rate through 2022 may also be impacting on borrowing decisions and affordability for some SMEs.

Overdraft applications, however, rose on the quarter and represented the highest volume of applications since 2020 Q1. The divergent trends across loans and overdraft applications, which have been evident throughout the year to date, continue to point to cashflow management and working capital requirements rather than business development driving new finance applications. This is further reflected in the continuing increases in advances through invoice finance and asset-based lending facilities.

Turning to the volume of applications approved by sector ***(Chart 3)***, we again see an increasing degree of variation across industry sectors – in sharp contrast to the position during the operation of government-backed loans, during which applications and approvals for finance were evenly spread across sectors. It is, however, important to note that while the volume of approved applications is moving in different directions across different sectors, the trend in approval rates throughout this year has remained stable at around seven in ten loans and nearly eight in ten overdrafts.

Chart 3: Number of approved loans and overdrafts by sector



Source: UK Finance

Key sector trends over the quarter include a second consecutive quarter of falling loans and overdrafts in the agriculture sector. There may be seasonal factors in play, in addition to post-Brexit changes to payments to the agriculture sector which the UK began transitioning to in 2022.

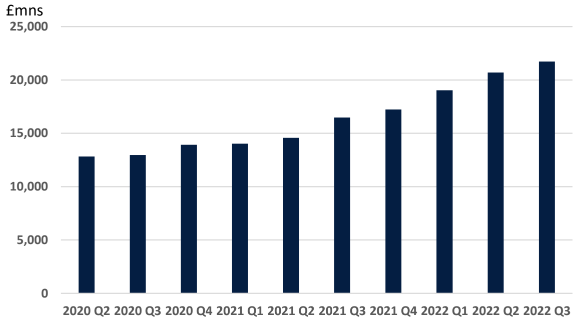
Following a drop off last quarter, there was an increase in finance approvals to the construction, and wholesale and retail sectors in Q3. The rise in input costs, particularly in construction, may be placing greater demands on SMEs' cashflow. Across remaining sectors the picture was largely unchanged from trends reported earlier in the year. The manufacturing sector is considered in more detail in our regular sector spotlight.

Previous finance reviews have highlighted invoice finance and asset-based lending (IF/ABL) as a particular growth area. In large part, we have attributed this to the cashflow management story that has become more important for SMEs through 2022.

Consistent with what we have seen in overdrafts in the past quarter**,** our data also note continued growth in IF/ABL advances in the three months to September. The level of advances has now surpassed those reported in 2020 Q1 and is approaching the levels seen in 2018/19. There have now been nine consecutive quarters of growth, with advances at the close of Q3 2022 standing at almost £22 billion, up five per cent quarter-on-quarter and up over 30 per cent on the same quarter in 2021. There was strong growth in the clients that are supported by IF or ABL facilities, with total client sales up 14 per cent in the year-to-date (compared with the first three quarters of 2021).

[Members of UK Finance's IF/ABL product and service area will be able to access the full quarterly data here.]

Chart 4: Value of invoice finance and asset-based lending advances



Source: UK Finance

Note: IF/ABL data includes advances to client businesses of all sizes

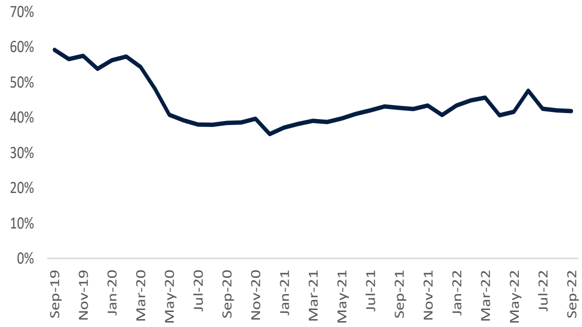
Financial headroom

One of the most consistent stories through and post-Covid-19 is the degree of financial flexibility available to SMEs within their arranged facilities and cash deposits. This remains the case in the most recent quarter.

We have discussed the recent increase in demand for new overdraft facilities, however we are not seeing much movement in the utilisation of existing facilities. ***Chart 5*** shows that while overdraft utilisation nudged higher over Q2, usage rates ticked down again in Q3 and remain lower than reported pre-pandemic and SMEs therefore retain a large degree of headroom within arranged overdraft facilities.

However, despite the sector variations in finance applications reported above, there are no discernible differences in the use of overdrafts across industries, with little movement during 2022 so far, in utilisation rates, across all sectors.

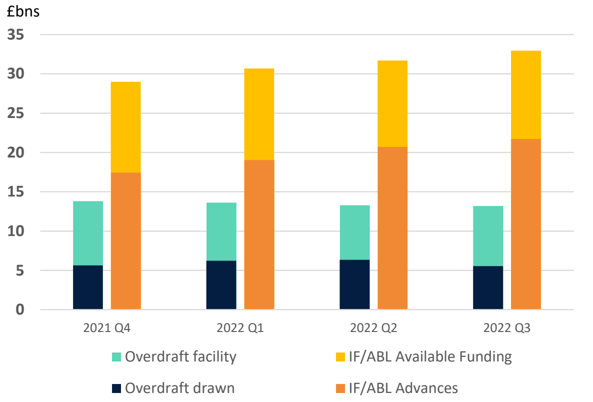
Chart 5: Overdraft utilisation, percentage



Source: UK Finance

The same holds for available funding within invoice finance and asset-based lending facilities. ***Chart 6*** shows the steady increase in advances over the past year, of which over a fairly stable one third are unutilised.

Chart 6: Available overdraft and IF/ABL funding



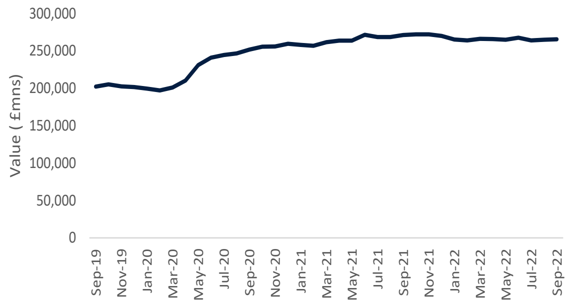
Source: UK Finance

The final element of available flexibility is cash deposits (***chart 7***). Once again, we continue to see relatively modest changes in the aggregate picture across SMEs. At the end of Q3 total deposits fell by just under one per cent compared with three months previous, and by two per cent relative to the same period a year ago.

This remains consistent with survey-based metrics of cash availability. The SME Finance Monitor, for example, confirms that in the first half of this year the proportion of SMEs holding more than £10,000 in credit balanced has been fairly stable since 2021 Q4 and higher than levels reported pre-pandemic.

However, there are, once again, some sector variations in our data. There has been a somewhat larger quarter-on-quarter drop off in deposits in accommodation and food service activities, and health and social care. In contrast cash deposits trended higher in construction and real estate.

Chart 7: SME Deposits



Source: UK Finance

Quarterly corporate insolvency numbers rising – but not the full picture

As soon as the full scale of the impact of the Covid-19 pandemic became apparent, many expected a commensurate surge in insolvency numbers given the initial economic damage caused to businesses across the country.

However, corporate insolvencies fell to their lowest level since relevant records began in 2000. The reasons for this fall were clear: unprecedented levels of financial support from government, much delivered through the financial services industry, combined with legislative measures to protect debtors by imposing temporary restrictions on creditor powers. At their lowest point, insolvency numbers were almost a third of this peak (2,358 in Q1 2021) during the 2008 financial crisis (6,954 in Q4 2008).

For some time many have questioned when the 'correction' may arrive with the closures and job losses typically associated with high levels of insolvency. And while insolvencies have now risen sharply since Q1 2022 – to well above their pre-pandemic levels – the headline number is still below expectations.

The latest quarterly (Q3 2022) statistics published by the Insolvency Service show that there were 5,595 corporate insolvencies, which comprised largely of 4,800 Creditor Voluntary Liquidations (CVLs). This type of procedure is initiated by company directors who typically, although not exclusively, determine their trading prospects to be sufficiently poor so as to warrant the winding-down of their firm.

Compulsory liquidations (492), administrations (274) and Company Voluntary Arrangements (CVAs) (29) made up the remainder. In contrast to the number of CVLs, usage of all three of these procedures remains well below their pre-pandemic levels. Compulsory liquidations and administrations tend to be creditor led, while administrations and CVAs are typically used to enable insolvency office holders and directors, respectively, to seek to rescue and restructure insolvent but potentially viable companies.

This can be seen as partly indicative of the forbearance and general support for UK business demonstrated by the financial services sector during the pandemic. The dominance of director-led processes over creditor-led processes suggests that while there is significant financial pressure on many companies, this is not yet at a level across the economy to warrant creditors in significant numbers to take action through the insolvency framework to seek to recoup the debts owed to them.

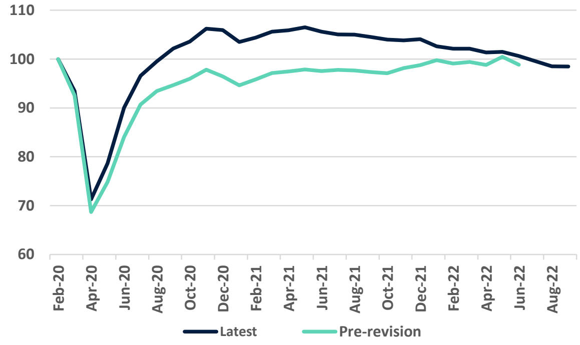
With many of the wider challenges facing the economy unlikely to recede soon, this split may become less pronounced and lead to the more typical insolvency picture that many have been expecting for some time.

SPOTLIGHT: MANUFACTURING

We return to the manufacturing sector this quarter, which we first covered in our 2021 Q4 Review. Since then, a number of material revisions to official statistics point to a much stronger post-Covid-19 recovery than previously thought. However, more recent indicators show that manufacturers are facing a range of headwinds, including rising costs, a slowing global economy and the challenges of a new trading relationship with the EU.

Chart 8 *shows the path of manufacturing output from the onset of the pandemic. Initial data suggested the post-Covid-19 recovery was short-lived with output never returning to pre-pandemic levels. However, the revised position shows a much strong rebound out of lockdowns, with all parts of manufacturing bouncing back at the end of 2020 and output surpassing February 2020 levels in the autumn of that year. Supply chain disruptions that came from global reopening put the brakes on recovery in 2021, but there are clearer signs of weakening from the start of 2022.*

Chart 8: GVA index February 2020=100



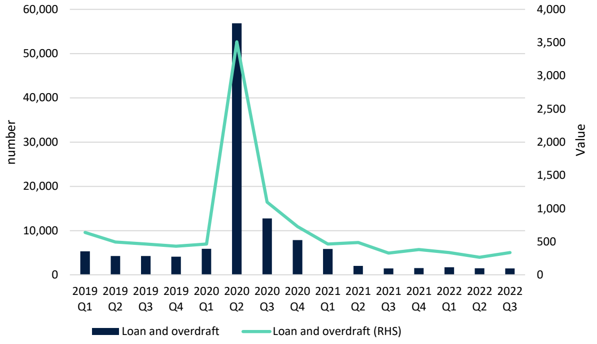
Source: ONS

While the weakness through 2022 so far has been fairly broad-based across manufacturing, there is notable weakness in chemicals, metals and machinery – potentially as a sign of the impact of higher energy costs, and in the case of machinery, weaker global investment intentions. The outlook heading into the final months of this year points to further slowing in activity and more subdued confidence, with the same factors weighing on activity in the year to date continuing to hamper growth into 2023 – high energy and other input costs, weak domestic and export demand, and disruption from the ongoing Ukraine conflict.

Turning now to recent developments in finance for the manufacturing sector, ***chart 9*** *shows a similar lending approval picture in the year to date as broader SME trends. The volume of applications approved has tailed off somewhat in the past two quarters. While values approved have been somewhat more volatile over the past year, in Q3 the value of approved lending has settled at a level similar to that seen at the end of last year.*

In line with that reported for the wider SME population, the pick-up in approvals over the quarter is largely an overdraft demand story rather than growth in applications for loans. This would suggest that the rise in costs, particularly energy price increases, are likely to be weighing more heavily on energy-intensive parts of the industry.

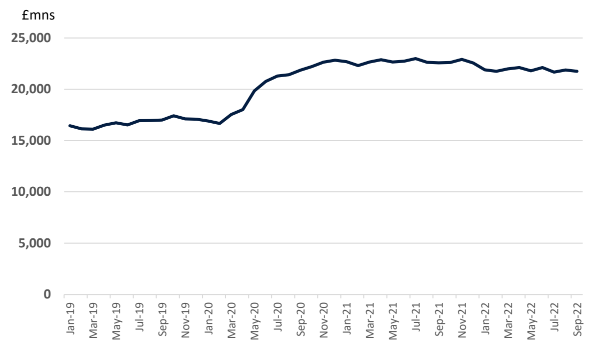
Chart 9: Loan and overdraft approvals



Source: UK Finance

Chart 10 shows the accumulation of deposits among manufacturers. The sector saw a slighter more significant build-up of cash during the Covid-19 pandemic. At their peak, deposit levels were 37 per cent higher than pre-pandemic – a combination of manufacturing being more likely to access the government-backed lending schemes that were available in 2020/21 and the stronger rebound after initial lockdowns than many *other sectors. However, there has been a slightly faster rundown of these in recent quarters than average – a likely outcome of the pressures already discussed.*

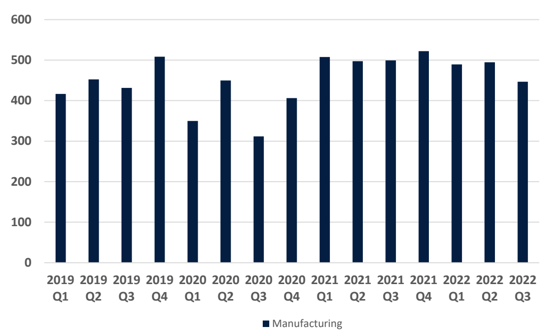
Chart 10: SME Deposits



Source: UK Finance

Finally, the manufacturing sector is following the same repayment behaviour as that seen in the rest of the economy. Again, however, we saw a sharper uptick in post-pandemic repayments than other industries, likely linked to activity returning to pre-Covid-19 levels faster than other parts of the economy and businesses paying down precautionary BBLS and CBILS borrowing. Surveys from ONS continue to points to a relatively high degree of confidence that manufacturers can continue to meet repayment obligations – a position that has been stable throughout this year.

Chart 11: Repayments



Source: UK Finance

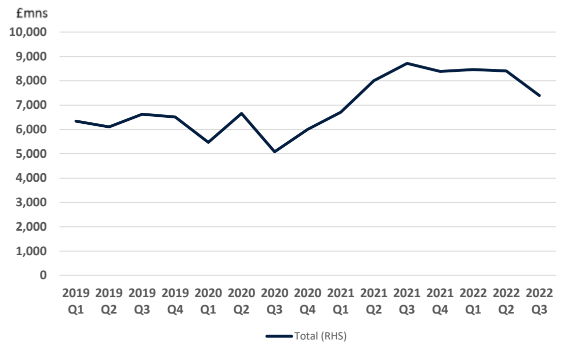
The outlook for the sector has undoubtedly becoming more challenging, with threats to activity from higher costs, skills shortages and slower global demand likely to be key to the growth outlook through 2023.

Repayments

The value of repayments by SMEs had been stable at around £8 billion over the past year as repayments for government-backed loans began to fall due. The most recent quarter has, however, seen something of a tailing off in repayment values, while still trending ahead of pre-Covid-19 (***chart 12***). The decline was particularly notable amongst the larger SMEs, with repayments by SME with a turnover of up to £2 million remaining stable.

This may be a reflection of the pace of full repayments of government-backed loans. We saw from data published by HM Treasury that as of end July around ten per cent of BBLS loans had been fully repaid. It may be the case that the rate at which those businesses that did not fully utilise the funding and decided to repay it in full as the interest-free period came to an end, is slowing down. Further discussions with lenders which provide data suggest that this is not (at least as yet) an indication of building payment challenges as economic conditions have deteriorated.

Chart 12: Value of repayments



Source: UK Finance

Outlook for SME finance

Demand for finance amongst SMEs has been relatively subdued so far in 2022 – the first full year, that businesses have been relatively unaffected by Covid-19 headwinds. However, other challenges have come to the fore. For some sectors this started with post-pandemic supply chain disruptions, which were exacerbated by the Russian invasion of

Ukraine. And linked to that, the global rise in energy and other input costs which have pushed up operational costs and squeezed consumer incomes, with knock on impacts on demand.

So far we see business managing these challenges with existing resources and some uptick in demand for finance to manage cashflow. While survey indicators show that confidence has ebbed away somewhat, there is still relative confidence about being able to navigate these headwinds and continue to meet any debt repayment obligations. We will be keeping a close eye on how these metrics develop as we enter a period of recession in the early part of 2023.

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